

Franchising 101: Registration and Disclosure Issues

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I. BACKGROUND OF FRANCHISE LAWS.

A. Early Franchises .

Singer Sewing Machine Company's network of sales and service "agents" in the 1850s, brewery-licensed beer gardens dating back to the 1900s and even the Catholic Church's tax collection practices during the Middle Ages have been cited as pioneer franchises. According to a FTC report, in 1950 fewer than 100 franchisors and 100,000 franchised units existed. Between 1969 and 1992 the number of franchise establishments increased by 45%. According to the IFA, in 1992 almost 41% of all retail sales in the United States were attributed to franchise outlets.

B. Solving the Problem of "Scams"

In its exponential growth in the 1960s franchise sales were fraught with fraud and abuse and complaints on the part of franchisees. As investor loss became more widespread, the legislators took up the task of enacting consumer protection statutes to regulate the offer and sale of franchises. California was the first State to enact a disclosure/registration law which became effective in 1971.

1. Federal Trade Commission Rule.

Following California's lead, in 1972 the FTC began proceedings to promulgate a trade regulation rule on franchise sales and presale disclosures to protect investors from fraud. The FTC Rule was not effective until 1979.

Unlike California, the FTC did not enact any federal registration procedures and limited its rule to disclosure issues. The FTC Rule does not preempt state laws, does not provide a private right of action and does not include any "relationship" provisions. Like California, the FTC enacted a rule requiring sellers of franchises and other business opportunities to deliver to prospective buyers the information needed to make an informed investment decision.

A basic disclosure document, consisting of 20 items of disclosure, earnings claims requirements and deliver requirements are all part of the FTC Rule. (See 10-day and 5-day Rules below) The FTC has ruled that a franchisor can use the FTC format or the UFOC format (described below), but may not mix and match at will. The FTC format is only acceptable in some states but the UFOC format has been approved by all registration states and so it is the format predominantly used.

The FTC Rule (not the disclosure document format) governs in all states, and must be complied with. Most registration states (listed below) have more stringent requirements than the FTC Rule and thus both state and federal laws must be considered.

2. State Registration Laws.

Fifteen states currently require some form of filing in connection with an offer or sale of a franchise. In alphabetical order, these states are as follows:

California	Hawaii	Illinois
Indiana	Maryland	Michigan
Minnesota	New York	North Dakota
Oregon	Rhode Island	South Dakota
Virginia	Washington	Wisconsin

3. "Post-Card" Registration States.

In addition to the states listed above, the following states currently require that a business opportunity exemption form be filed along with a fee ranging from \$25 - \$100:

Florida	Nebraska	Texas	Utah
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Most of these exemption forms are filed annually, although Texas is a one-time filing. Finally, certain miscellaneous provisions must be complied with. For example in Connecticut a copy of the registration information for a franchisor's federally registered trademark must be filed with a notice of exemption from the business opportunity statute. If the franchisor does not have a federally registered trademark, the franchisor must register under the Connecticut Business Opportunity Act.

C. State "Little FTC Acts".

Worth mention are various state laws governing the ongoing franchise relationship after disclosure and registration issues have been faced. Some states require certain notice and "good cause" standards for non-renewal, cancellation and termination of the franchise relationship. These provisions vary widely from state to state and should be carefully consulted in drafting a franchise agreement. In California, these provisions are called the California Franchise Relationship Law (CFRA) and can be found beginning at Section 20000 of the California Business and Professions Code.

II. CALIFORNIA FRANCHISE INVESTMENT LAW ("CFIL")

The CFIL is found beginning at Section 31000 of the California Corporations Code. The regulations promulgated thereunder are found at Title 10, Chapter 3, Subchapter 2.6, Sections 310.000 – 310.505 of the California Administrative Code.

A. Offers Made "in this State"/Jurisdiction

A franchisor must register in California any offer OR sale of a franchise in this State. An offer OR sale of a franchise is made in California if:

- 1. An offer to sell is made in this state;**
- 2. an offer to buy is accepted in this state or**
- 3. the franchisee is domiciled in this state and the franchised business is or will be operated in this state.**

An offer to sell is made in this state when:

- 1. the offer either originates from this state or is directed to and received and accepted (as defined) in this state.**

The jurisdictional provisions in each registration state vary and should be separately

consulted and analyzed as to application in a particular instance.

B. Application for Registration

In California, an application for registration is filed with the Department of Corporations, which undertakes a rigorous review of all such applications. Some other state agencies include, Securities Divisions, Departments of Commerce, Secretaries of State and numerous other state agencies appointed to oversee that state's franchise registration process.

California, like all registration states, follows the UFOC guidelines and requires the standard application form documents which, along with the UFOC itself, include a cover page, notarized signature of an authorized officer, consent to service of process, Sales Agent disclosure forms, supplemental information concerning the other state registration applications filed or anticipated by franchisor, a budget, financial statements (and auditor's consent letter) and the application fee (currently \$675.00 in California). Any advertising used to promote the sale of the franchises must also be included.

1. Review and Comment Process

Upon submitting an application for registration in California, the franchisor will receive acknowledgement of the receipt of the application and a document waiving the automatic effective date of the application. Under the CFIL, an application is effective on the 15th day after filing, but because of the demands on the franchise examiners, the waiver is sent (usually by fax) and signed as a matter of course in order to place a "stop order" on the automatic effective date.

Franchise registration applications are not reviewed on a merit basis, rather for compliance with the requirements of the application including ensuring that all of the 23 items of disclosure have been met. In other words, it does not matter that bankruptcies and suits for fraud are disclosed in the UFOC, only that all such matters are fully disclosed for review and consideration by the prospective investor. Examiners are left some discretion to deny registration, however. For example if a person with management responsibilities is a convicted felon and this would represent an unreasonable risk to investors, the registration might be denied, however, such instances are rare.

The examiners send comments to the Franchisor's counsel or other submitting representative, usually by letter, but for minor requests, an examiner may simply telephone regarding comments. The necessary revisions are then resubmitted with a redlined copy to the examiner who may issue an order of effectiveness or send additional comments. Each state has a slightly different process and a franchisor must try to deal with each state on that state's terms in order to register to sell its franchises.

Pursuant to a Commissioner's regulation, registrations in California expire 110 days after the franchisor's fiscal year end which can sometimes cut short a registration which in other states would be effective for one year from the effective date. (See Renewals discussion below).

2. Amendment and Renewal

During the first year that a franchisor is registered they should anticipate filing several amendments due to the "fine tuning" many new to franchising experience as various situations arise. Any material change in the information disclosed must be made in the form of an amendment. An amendment application and \$50.00 filing fee in California must accompany each "post-effective" amendment. Amendments may be made prior to the effective date if something is changed while the application is still pending. These "pre-effective" amendments are free. The precise

meaning of "material" in California is unclear but under the FTC Rule it generally includes information or circumstances having a substantial likelihood of influencing or having a significant financial impact on a reasonable franchisee (or prospective franchisee) in the decision to buy the franchise.

Renewal for additional one year periods may be filed if a franchisor wishes to continue offering or selling in California and wants to avoid a lapse in the registration and having to start over in the registration process paying another filing fee rather than the lower \$450.00 Renewal Fee. To maintain continuous registration effectiveness, a franchisor must file the renewal at least 15 business days before the anniversary date. In this manner, the franchisor's registration will automatically become effective on the anniversary date unless a stop order is issued. The information submitted is similar to initial registrations but includes a redlined copy of the changes made to the UFOC and accompanying documents. The renewal application then goes through a similar review and comment process as described above, but usually is not as lengthy.

3. Negotiated Sales

Although it is not recommended, negotiations concerning the terms of the offering as described in the UFOC do occur. These can lead to some severe consequences in that an offer or sale which is NOT registered has likely occurred. Oddly, most of these negotiations end up with the franchisee on the winning end but nevertheless will need to be disclosed to subsequent prospects. As long as the prescribed notice form is complied with, California allows negotiated sales when filed before any subsequent franchise sale occurs or at the latest, 15 business days from the sale date and delivered to all prospects along with the UFOC documents for the next 12 months following the negotiated sale.

4. Advertising

Most franchisors advertise the sale of their franchises in some form either brochure, website, television, radio or other medium. All such ads must be filed with the Department of Corporations 3 days prior to publication unless exempted. Such exemptions are provided for ads placed in a newspaper with a general, regular circulation which has had more than two-thirds of its circulation outside the state during the past 12 months or a radio or television program originating outside this state received in the state.

As of January 25, 2001, California (joining several other registration states) adopted its "Internet Offer" exemption. Unfortunately, examiners require that franchisors who offer or sell franchises on websites continue to file such websites materials as advertisements, but the Internet Offer exemption allows a franchisor to exempt itself from the franchise registration requirements if the Internet Offer 1) indicates directly or indirectly that the franchise is not being offered to California residents, 2) is not otherwise directed to any person in California by or on behalf of the franchisor or its agent and 3) no franchise sale is made in California until the offering is registered under the CFIL.

5. Material Modification

Unique to California, are the "material modification" provisions of the CFIL. If material changes are made to an existing franchise relationship, those changes must be filed in the form of an application for registration of a material modification. It is unlawful to solicit the agreement of a franchisee to a proposed material modification of an existing franchise unless the written disclosure document is first delivered in the form prescribed either (1) 5 business days before signing the

modified agreement or (2) the disclosure contains a statement that the franchisee may rescind the modified agreement no less than 5 business days after signing. An exemption is available if the modification is the result of a bona fide dispute due to a franchisee default, the written modification is received by the franchisee at least 5 business days before signing (with some additional requirements) AND the change is not systemwide.

III. DISCLOSURE

A. Uniform Franchise Offering Circular ("UFOC")

The Franchisor must disclose information in its prospectus type document called the Uniform Franchise Offering Circular or "UFOC". This UFOC format was established by the Midwest Securities Commissioners Association and is now in the hands of the North American Securities Administrators Association (NASAA).

1. 23 Items of Disclosure

Every UFOC must contain information divided into twenty-three separate disclosure items as prescribed by NASAA. The UFOC Guidelines and Instructions are quite lengthy and require in depth analysis in preparing a UFOC. The 23 UFOC disclosure items are summarized briefly as follows:

Item 1: The Franchisor, its Predecessors and Affiliates. The identity, business and experience of the franchisor (as well as defined affiliates and predecessors) must be set forth along with a description of the franchised business, including information about the market for the goods or services offered, the competition and regulations that apply to the franchisor's specific industry.

Item 2: Business Experience. The identities and last 5 years' business experience of the franchisor's officers, directors, general partners, trustees, and others who will have management responsibility relating to the franchise.

Item 3: Litigation. Specified types of pending and concluded material litigation against the franchisor, persons disclosed in Item 2, predecessors and affiliates (as defined) must be disclosed.

Item 4: Bankruptcy. Information concerning bankruptcy proceedings by or involving the franchisor, its affiliate, predecessor, officers or general partners during the 10-year period immediately before the date of the UFOC.

Item 5: Initial Franchise Fees. All initial fees charged in connection with the purchase of the franchise for goods or services received from the franchisor before the franchise opens.

Item 6: Other Fees. The recurring and non-recurring fees paid by the franchisee, i.e., royalties. Requires a table for clarity.

Item 7: Initial Investment. The franchisee's initial investment for items like real property, furniture, fixtures, equipment, inventory and business licenses etc. to open the franchise and operate it for some "initial period". Also requires a table for clarity.

Item 8: Restrictions on Sources of Products and Services. Franchisors may set certain restrictions on the goods and services that the franchisee will need in the business. For example a franchisor

could require that various inventory sold be purchased from a certain vendor with whom the franchisor has established a good rate for the quality of goods the franchisor seeks. If the franchisor gets any remuneration from any such vendor, the details of such payments must also be disclosed.

Item 9: Franchisee's obligations. These consist of matters including, site selection, training, compliance with manuals and standards established by the Franchisor, Advertising, Post-termination no-competes and confidentiality.

Item 10: Financing. Whether the franchisor, its affiliate or agent offers financing of all or any part of the fees paid by the franchisee this must be disclosed with a copy of all notes, contracts etc... attached.

Item 11: Franchisor's Obligations. These consist of matters including, site approval, training programs, required computer systems and advertising programs.

Item 12: Territory. Rights and restrictions to any exclusive or non-exclusive area are described here. Also includes Franchisor's rights to establish another franchise or company-owned unit using the names and marks and rights to alternative distribution channels using the names and marks. This has become a very significant issue in that Franchisor's must expressly reserve rights to Internet, web sites, URLs and other electronic commerce or lose it according to the most recent decisions in this area.

Item 13: Trademarks. The principal trademarks licensed to franchisee are described and registration information listed. Non-registered trademarks require that a disclaimer be stated. Any limitations on a franchisor's use of the marks or material determinations must also be discussed.

Item 14: Patents, Copyrights and Proprietary Information. Descriptions of these rights and their relationship to the franchise is required, including Confidential Information and Trade Secrets.

Item 15: Obligation to Participate in the Actual Operation of the Franchise Business. Some franchisors do not require that the Franchisee participate directly and personally in the actual operation of the franchise business but will permit a manager who has been trained to do so as long as certain requirements are met. Other franchisors require that individual franchisees directly supervise the on-site activities of the franchise.

Item 16: Restrictions on What the Franchisee May Sell. Restrictions or conditions on the goods or services that the franchisee may sell or that limit the customers to whom the franchisee may sell are disclosed here.

Item 17: Renewal, Termination, Transfer and Dispute Resolution. A summary of the contractual provisions including the term, renewal, termination, transfer, and dispute resolution. Table is required to easily cross-reference sections in the franchise agreement and other contracts.

Item 18: Public Figures. Compensation for endorsement of the

franchise (not the goods or services sold), management involvement of public figure and investments made in the franchisor by a public figure must be disclosed.

Item 19: Earnings Claims. A Franchisor must either provide information on past financial performance that is substantiated by considerable data and in the required format or provide no information at all, called a “negative disclosure”, in accordance with prescribed language.

Item 20: List of Outlets. Most recent three years’ statistics on current franchise units regarding units terminated, transferred or otherwise left the system and on company-owned units opened or closed and projected openings of new franchises for next fiscal year. Names, addresses and phone numbers of franchisees are listed. Table format required for clarity.

Item 21: Financial Statements. Normally requires an audit and prepared according to GAAP. (See Financial Statements discussed below).

Item 22: Contracts. Each UFOC delivered to a prospective franchisee must include copies of all agreements to be offered. These include, the franchise agreement, leases, subleases, guaranties of performance, financing agreements and other documents attached to the UFOC.

Item 23: Receipt. The last page of the UFOC is a detachable document acknowledging receipt of the UFOC by the prospective franchisee and must contain certain information and statements.

2. Timing of Delivery

In order to allow the prospective buyer adequate time to review, and have the appropriate business professionals advise the investor on the terms of the franchise investment, both federal and state requirements impose waiting periods after the proper documents are delivered.

10-Day Rule. Under the FTC Rule, applicable in all states, the disclosure document (whether it be the UFOC or FTC format) must be delivered to the prospective franchisee at the earlier of the first personal meeting to discuss the franchise or ten business days prior to signing the contract or paying for the franchise. California’s delivery requirements are the same as the FTC Rule but some registration states require different, more stringent delivery requirements, i.e., Illinois requires 14 days.

5-Day Rule. A copy of the finalized franchise contract and related agreements must be delivered at least five business days prior to signing, under the FTC Rule. Again, specific state laws should also be consulted to ensure compliance.

3. Financial Statements

Under the UFOC guidelines, (under Item 21) franchisor’s must provide financial statements in accordance with GAAP and audited by an independent CPA including the franchisor’s balance sheets for the last two fiscal years before the application date, statements of operations, of stockholders equity and of cash flows for each of the franchisor’s last three fiscal years. Unaudited statements may only be used for interim periods. Some registration states allow franchisor’s to “phase-in” audited financials, permitting the submission of reviewed financials for the first year of

registration under very limited circumstances. One common method to avoid the expense and time delays caused by audits, is to incorporate a new franchise entity just prior to filing the registration applications. In this way, the new franchise entity will have only a limited financial history, minimizing the preparation time and expense associated with financial statements.

Alternatively, a franchisor may submit the financial statements of a parent or other affiliated company if the parent or affiliate absolutely and unconditionally guarantees (in writing) to assume all obligations of the franchisor under the franchise agreement.

4. Earnings Claims

If information is given to a prospective franchisee from which a certain level or range of actual or potential sales, costs, income or profit from franchised or non-franchised units can easily be ascertained, then a reasonable basis must be provided for such data in the form specified. If no information on earnings or potential earnings is provided, then the negative disclosure prescribed in the UFOC guidelines must be made.

One of the most highly debated issues among franchise practitioners and regulators is on the topic of earnings claims. One school of thought holds the position that earnings claims should be made mandatory for all franchisors creating a more "level playing field"; the other believes that the current choice between substantiation of earnings claims or negative earnings claims should remain.

Some start-up franchisors with no real franchise unit track record on which to base an earnings claim refer prospects to the franchisees listed in Item 20 to share their information (on a voluntary basis) with the prospect. This helps to alleviate the dilemma faced by such start-up franchisors when confronted by prospective franchisees demanding to know the profit potential of the investment. There are also some exceptions that allow a franchisor to make limited earnings claims as to a specific unit being considered for purchase but strict compliance with these exceptions is critical.

IV. Penalties for Non-Compliance

1. Rescission

2. Damages

3. Attorneys Fees

4. Civil and criminal penalties, including imprisonment.

5. FTC enforcement stepped up and heavy judgments of several million dollars.

V. Several New UFOC Changes To Be Announced Soon

The FTC is in the process of substantially changing many of the provisions of the current FTC Rule governing franchising. In response to electronic and technological developments in the way franchises operate, including delivery of UFOC documents to prospective franchisees, the FTC is attempting to keep the FTC Rule current with the electronic age. It is anticipated that these changes will have a significant impact on the existing methods of disclosure and once effective, will likely modify and make obsolete many of the provisions described in this paper. Please proceed with caution and consult the most recent franchise rules and regulations carefully.

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